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CORRESPONDENCE MEMORANDUM

DATE: April 20, 2005

TO: Wisconsin Deferred Compensation Board

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Defaulting Closed Fund Account Balances

Prior to the removal of the Janus Fund and the T. Rowe Price International Stock Fund at the end of 2005, the Investment Committee and staff recommend that the Board reconsider its policy of defaulting or "sweeping" closed fund accounts to the Vanguard Money Market fund. The Investment Committee carefully reviewed all aspects of this policy question and did not come to a definitive decision or a recommendation for the Board. This memo provides the framework for the Board's discussion of this policy decision on May 10, 2005.

BACKGROUND

According to chapter ETF 70.08 (3), Wisconsin Administrative Code, after the Board has determined that a fund is no longer acceptable for inclusion in the Wisconsin Deferred Compensation (WDC) Program, the Board is required to tell the WDC administrator to which other WDC fund any remaining participant account balances from the closed fund should be automatically moved or "swept." The administrative rule *does not* specify to which fund the money is to be swept; that decision is left to the Board.

Selecting a default fund option when removing or replacing an investment option is a fiduciary duty, since the Board is making an investment decision for participants instead of the decision being directed by the participant. In the past when a fund has been removed, the Board has directed that any remaining account balances be swept to the Vanguard Money Market Fund, one of the WDC's more conservative investment options.

The preamble to section 404(c) of the Employee Retirement Income Security Act (ERISA) states that "plan fiduciaries will not be relieved of responsibility for investment decisions under an ERISA section 404(c) plan unless those [investment] decisions have affirmatively been made by participants…" Like most other public retirement plans, the WDC is not directly subject to ERISA. However, in practice most public plans seek to abide by ERISA regulations as they provide guidance on federal interpretations of situations that are also experienced by public plans. Attachment A includes remarks made by Fred Reish in 2002 that summarize the mixture of questions that arise when considering default accounts.

As shown in the table on the following page, the Board has periodically removed investment options from the WDC. Since 1997, the Board has removed four investment options from the WDC and swept the remaining accounts to the Vanguard Money Market fund. These removals

Reviewed and approved by Dave Stella, Deputy Secretary

Signature Date

affected 4,351 participant accounts. As of March 1, 2005, 2,757 participants (63%) still held assets in the Vanguard Money Market fund.

Although we may never know for sure why participants have failed to move their balances out of the money market fund, it is troubling that so many remain in the default fund despite repeated requests and reminders to move their balances. It suggests that some WDC participants may not be actively managing their accounts for optimal financial advantage.

WDC FUND CLOSURE HISTORY

Fund Name	Date Closed	Number of Accounts	Value of Accounts*	Number Remaining in Money Market	Percent Remaining in Money Market
Dreyfus Premier Third Century	12-31-04	1,849	$6,081,547	1,668	90%
Seligman Capital	12-31-99	778	$7,202,451	358	46%
Twentieth Century Growth	12-31-98	1,042	$11,326,219	423	41%
Twentieth Century Select	12-31-97	682	$6,402,527	308	45%
Total		4,351	$31,012,744	2,757	63%

* as of the date the fund was closed and the accounts were transferred

INDUSTRY PRACTICES

The industry best practice regarding where to move closed fund accounts appears to be to an option in the same asset class. According to the results of "Plans in Transition: IOMA's Annual Defined Contribution Survey," published in the August 10, 2004, edition of the Institute of Management and Administration's DC Plan Investing newsletter, approximately 77% of plan sponsors (primarily 401(k) plan providers) responding to the survey sweep assets from closed funds to a fund offered by a different investment provider that is in the same asset class and has similar style and characteristics as the closed fund. The larger the plan is, the more likely they were to sweep funds to a similar fund. About 7% of all respondents indicated that they sweep default funds to a money market.

Moving closed funds to a like fund in the same asset class and not to a money market fund appears to be the default of choice of most government-sponsored deferred compensation programs as well as private 401(k) plans. Staff queried the National Association of Government Defined Contribution Administrators (NAGDCA) and 11 of 13 government-sponsored[1] plans responding indicated that they move closed fund account balances to a like fund and not to a money market fund. One plan sweeps to a balanced fund. The WDC administrator, Nationwide Retirement Solutions (NRS), also states that the majority of their large government clients and other governmental clients, including the National Association of Counties and the US Conference of Mayors,[2] all sweep terminated funds to a similar asset class fund.

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[1] Sweep to similar asset class funds: states of CT, CO, TN, MD, MI, FL, Multnomah county (WA), cities of Seattle, Pasadena and Anaheim, and Denver Water. One ME local employer "walls off" funds (remain in program but closed). One state (TX) sweeps to a balanced fund.
[2] States of CA, KY, AZ, MD, NM, Ohio STRS, Phoenix, and Maricopa County (AZ). One county (Solano Co., CA) "walls off" funds. NY has mapped to both stable value and a similar asset class fund.

DISCUSSION
The process that is followed to arrive at a decision regarding defaulting closed fund account balances should demonstrate that the Board has exercised due diligence when making its decision.

When selecting a default fund, the following points should be considered:

1. **What are the objectives of the WDC?**
   The WDC is a supplemental retirement savings program. As such, the WDC provides participants with the opportunity to invest a portion of their annual earnings in investment options on a tax-deferred basis.

2. **What are the Board's responsibilities?**
   The Board has fiduciary responsibility for the WDC. As fiduciaries, Board members have a duty to exercise diligence and prudence in their actions, including acting as experienced or knowledgeable investors when making decisions. When selecting a default option, the Board needs to consider all available information, its past practices as well as legal advice. Accordingly, NRS' legal counsel was present at the Investment Committee meeting via teleconference and will be available for questions at the WDC Board meeting.

   The Board is responsible for establishing criteria and procedures for selecting and evaluating investment options offered by the WDC, including choosing the asset classes to be offered and the fund managers in those classes. In recognition of these responsibilities, the Board has established a thorough investment option selection methodology and a process for monitoring performance of investment option selected for inclusion in the WDC. With the help and advice of the Investment Committee, the Board systematically reviews and monitors WDC investment options to ensure that the options remain suitable for WDC participants.

3. **What are the participants' responsibilities?**
   WDC participants are responsible for selecting the investment options within the asset classes in which to invest and the amount to place in each. These are choices made by each individual who decides to participate in the WDC.

DEFAULT OPTIONS
There are several default options available to the Board. Attachment B provides the range of options available to the Board, along with the pros and cons of each option. In staff's opinion, the most feasible options are the following:

<u>Option 1: Default to the stable value fund</u>

- This option preserves principal and has more potential for investment return than a money market fund. Sweeping to the stable value fund takes a participant out of the asset class they originally selected.

AVERAGE ANNUAL RETURN AS OF MARCH 31, 2005		
	3 Year Average Annual Return	Five Year Average Annual Return
Stable Value	5.25%	5.77%
Money Market	1.32%	2.63%

- Moving participant accounts to the stable value fund may raise an issue if there are market-related return differences between the asset class the account was originally in and the stable value fund. In addition, there would be trading restrictions: the stable value fund has a 90-day equity wash rule.

Option 2: Default to a balanced fund or an age-appropriate lifecycle fund

This option has recently been recommended for consideration by the UW System Tax-Sheltered Annuity Review Committee (TSARC). If approved by the TSARC, the default fund for UW System accounts that are opened with no clear investment instructions will be the Fidelity lifecycle fund (in the "Freedom Fund" series) will be the fund with the target date closest to the participant's sixty-fifth birthday. (Fidelity is the current administrative services provider for the UW System program.) In making this recommendation, UW System noted that a money market fund is unlikely to keep up with inflation over the long term.

- This option may preserve participants' principal while providing for slightly more potential for investment return than a money market fund. However, it takes a participant out of the asset class they originally selected.
- It also may subject the Board to criticism, as the participant has not made the selection and the WDC may be held responsible for any market-related losses.

Option 3: Default to a fund in the same asset class

If the asset class has both active and passive funds and an actively managed fund is terminated, accounts will be defaulted to the active fund in the asset class. If there is no equivalent actively managed fund in the asset class, accounts will be swept to the passive fund.

- This option keeps participants in the asset class they originally selected, with the same levels of risk and return as the participant originally accepted.
- It also raises potential problems should participants lose principal in the new fund.

Option 4: Continue to default to the money market fund

- This option preserves principal, but takes a participant out of the asset class they originally selected.
- Moving participant accounts to the money market fund may expose the Board to risk, as the participant has not made the selection and the WDC may be held responsible for any market-related losses between the asset class the account was originally in and the money market.

RECOMMENDATION

Given the potential for large numbers of WDC participants to be in a position to be affected by the default policy, staff proposes that the Board consider changing the default fund for closed fund balances from the money market fund to the stable value fund. As stated previously, this option preserves principal and should provide for greater returns than what may be provided by the money market fund.

Staff will be available at the meeting to discuss this memo.

Attachments

ATTACHMENT B: WDC DEFAULT OPTIONS
April 20, 2005

DEFAULTING CLOSED FUND OPTIONS		
FUND	**PROS**	**CONS**
Money Market Fund	• Preserves participants' principal because it is a very conservative option	• May increase the Board's fiduciary risk: to default a participant to the money market fund would change the participant's asset class allocation and may be contrary to participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the money market fund • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants
Stable Value Fund	• Preserves participants' principal because it is a conservative option • Provides more potential for investment return than a money market fund while not necessarily increasing risk of loss of principal	• May increase the Board's fiduciary risk: to default a participant to the stable value fund would change the participant's asset class allocation and may be contrary to participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the stable value fund • Would have trading restrictions: the stable value fund has a 90 day equity wash rule • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants
Balanced Fund	• May preserve more of participants' principal because it is a conservative option	• May increase the Board's fiduciary risk: to default a participant to a balanced fund would change the participant's asset class allocation and may be contrary to participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the balanced fund • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants
Age-appropriate Lifecycle Fund	• May preserve more of participants' principal because the lifecycle fund will become more conservative as the participant ages • Provides more	• May increase the Board's fiduciary risk: to default a participant to the money market fund would change the participant's asset class allocation and may be contrary to participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the

DEFAULTING CLOSED FUND OPTIONS		
FUND	**PROS**	**CONS**
	potential for investment return than a stable value or money market fund while not necessarily increasing risk of loss of principal	participant's deleted fund and the loss of earnings between the participant's selected asset class and the money market fund • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants
Like Asset Class Fund (e.g., large cap to large cap)	• The participant stays in the asset class they originally selected • Generally, movement between like funds in an asset class should not incur market losses • May reduce the Board's fiduciary risk: the move can be defended by demonstrating that default fund is in the asset class originally selected by the participant	• May not preserve principal • May have to decide on which fund to send default accounts – an asset class may have both active and passive (index) funds • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants • May be problematic because the Board cannot know for sure if the participant has specifically selected the fund manager and the asset class or just the asset class
Establish account in same (closed) fund through Schwab Personal Choice Retirement Account (PCRA) Fund	• Participant remains in the exact fund they originally selected	• Proactively creating a brokerage window to keep a fund deemed unacceptable by the Board may be viewed as a breach of fiduciary duty. If the fund is removed from the WDC core, presumably for performance or other issues, why would it be appropriate to let participants remain in that fund through Schwab? • Sets precedent: if the Board permits this, is it prepared to make a similar decision with respect to any future investment option closings? • Undermines the Board's disclaimer of fiduciary responsibility for participants' PCRA decisions • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May not preserve principal • May not be offered by Schwab • May be confusing for participants • May change reimbursements to the Board • May be a cumbersome process • May have Schwab transaction fees • Would require contract amendment with Schwab

ATTACHMENT C: WDC DEFAULTING ACCOUNT COMMUNICATIONS
April 20, 2005

CURRENT COMMUNICATION EFFORTS
The efforts to inform participants of impending fund option closures begins soon after the Board has made the decision to close a fund. Current efforts include:

- Newsletter articles. Four to five articles in the WDC's quarterly newsletter, *MoneyTalks*, to alert participants of the fund closure and what steps they will need to take to ensure their assets are not redirected to the default investment option.

- Four individual letters sent to the participant.
  - The first letter is sent approximately 45 days prior to the June 1 date when the WDC stops deferrals into the closed investment option. Participants are provided information on other investment options that are available through the WDC as well as instructions on where they can find additional information or receive assistance to change their deferrals.

  - A second letter is sent with the deferral allocation confirmation. The letter explains the removal process and that as a result of the participant not changing their deferral allocation, the percentage that they had been deferring to the closed fund has been redirected to the default investment option. The participant is also provided instructions on who to contact if they would like to change their deferral allocation.

  - The third letter is sent approximately 45 days prior to the December 31 date when the WDC completely closes the investment option. Participants are again provided information on other investment options available through the WDC as well as instructions on where they can find additional information or receive assistance in moving their account assets.

  - The final letter explains the removal process and that as a result of the participants' inaction, their assets that were remaining in the closed fund have be exchanged to the default investment option. This letter is sent with the exchange confirmation. Participants are given instructions on how they can move their assets from the default option to another investment option within the WDC.

- Web site information. Through the removal process, information is also posted to the WDC Web site to alert participants of the pending fund closure. WDC staff also address the pending closure of funds when meeting with participants, either through an informational workshop, one-on-one meetings or through telephone contact.

PROPOSED ADDITIONAL COMMUNICATION EFFORTS
In addition to the communication efforts outlined above, staff proposes the following additional methods to communicate fund closures to participants:

- Include a "select and respond" page with the letters*.* The response page would provide a list of the options to which the participant could transfer their account balances, and could be faxed or mailed back to the WDC Office. Nationwide Retirement Solutions (NRS) experienced some success with a similar measure used as part of a special mailing recently to state employee participants receiving backpay lump sums as a result of union contract settlements.

- Call high account value individuals. Attachment D provides a breakdown of WDC participants by account value in both the Janus Fund and T. Rowe Price International Fund from October 1, 2004, through April 15, 2005. Staff recommend calling individual participants with balances greater than $100,000 who have not moved their account balances by October 15, 2005 to remind them of the fund closure and subsequent need to move their balances.

- Include a "pop-up" box on the WDC Web site that reminds participants that funds are closing and that they should move their account balances and change deferrals. Ideally, participants would then complete the process while they were online.

  Department staff have requested the addition of this feature to the WDC Web site. NRS has been planning the programming changes need for it and anticipates it will be available on the WDC Web site in early June 2005.

- Include a reminder message on the Integrated Voice Response telephone system that reminds participants currently in the funds that are closing to move their accounts. This message would also remind individual participants of the fund closure and need to move their balances. Ideally, participants would then complete the process while they were on the telephone.

ATTACHMENT D: JANUS AND T. ROWE PRICE INTERNATIONAL FUND DATA

PARTICIPANT ACCOUNTS

The tables below provide data as of April 15, 2005 on participant accounts in the Janus Fund and T. Rowe Price International Fund.

WDC JANUS ACCOUNTS			
Account Size	**# of Participants**	**Balance in $**	**Average in $**
$0-5,000	6,746	10,793,496.48	1,599.98
$5,001-25,000	2,317	24,316,794.07	10,494.95
$25,001-50,000	250	8,304,797.87	33,219.19
$50,001-100,000	47	3,119,896.96	66,380.79
$100,001 +	9	1,179,722.74	131,080.30
Total	9,369	47,714,708.12	5,092.83
	Largest	175,415.30	

WDC T. ROWE PRICE INTERNATIONAL ACCOUNTS			
Account Size	**# of Participants**	**Balance in $**	**Average in $**
$0-5,000	7,701	10,800,643.16	1,402.50
$5,001-25,000	2,310	24,252,846.81	10,499.07
$25,001-50,000	190	6,491,365.79	34,165.08
$50,001-100,000	39	2,478,428.42	63,549.45
$100,001 +	4	585,596.93	146,399.23
Total	10,244	44,608,881.11	4,354.64
	Largest	194,282.59	

ACCOUNT BALANCE MOVEMENT

This table provides data on the movement of funds from participants' Janus Fund and T. Rowe Price International Fund accounts from October 1, 2004 through March 22, 2004. It includes the number of participants moving funds, amounts moved, and to where the balances were moved.

	FROM JANUS	**FROM JANUS**	**FROM T. ROWE PRICE INT'L**	**FROM T. ROWE PRICE INT'L**
	AMOUNT	**#**	**AMOUNT**	**#**
EAFE Equity Index	$780,428.62	276	$6,428,070.14	1,069
MidCap Equity Index	$2,479,840.59	542	$773,012.78	214
Small Cap Index Fund	$1,078,554.05	307	$402,794.03	168
U.S. Debt Index Fund	$199,829.58	77	$135,705.28	23
Calvert Social Investment	$850,095.06	216	$108,911.83	45
Cash Account (used for end result exch)	$7,000,559.44	1,360	$5,948,358.04	1,680
DFA U.S. Micro Cap	$3,444,521.20	821	$1,358,644.65	382
Fidelity Contrafund	$11,042,986.26	2,088	$1,318,102.34	369
FDIC	$224,656.50	48	$166,588.27	32
Federated U.S. Gov't. Sec.	$200,216.71	67	$91,325.02	31
Stable Value	$4,585,137.57	673	$2,989,632.88	445
T. Rowe Price International	$603,543.79	219	---	---
Europacific	$329,415.77	81	$6,949,105.42	940
T. Rowe Price Midcap	$5,448,567.89	1,051	$1,539,880.80	386
Vanguard Institutional Index	$3,905,472.33	819	$743,869.63	203
Vanguard Admiral Money Market	$536,018.44	85	$159,061.74	38
Vanguard Wellington	$7,437,124.05	1,207	$2,022,572.19	392
Vanguard Long-Term Corp.	$2,374,878.49	416	$705,560.31	171
TOTALS	**$52,521,846.34**	**10,353**	**$31,841,195.35**	**6,588**